RIBA AND ISLAMIC BANKING

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Abstract

The Prophet admonished riba in its all forms in his farewell Pilgrimage speech. The article examines the principles of riba and how it fits within the realm of Islamic economics, as it is exemplified by the Prophet in his Sunnah and as it is described in the Holy Qur'an. Consecutive verses of the Qur'an and its interpretations through the hadiths of Prophet are also portrayed in the article. Referring to a debate saying the modernists claim that what is prohibited in al-Qur'an is the form of riba referred to the then prevailing practice of lending in the pre-Islamic era, the authors boldly ruled out the logic saying that any increase over and above the principal should be riba, and as such it is unlawful. The modernists also raised some debatable issues like-'difference between riba and usury' and 'individual and institutional riba'. All these claims are defeated with sufficient Shari`ah references. While responding the issues stated earlier, the authors categorically explored the inborn beauties of Islamic Banking as well as disclosed the distinctions between Islamic and Conventional Bank. The authors, in a nut shell, stress on the point in this paper that any form of riba is strictly avoided in the Islamic Banking System.

1. Introduction

The last sermon in the farewell Hajj given by the Prophet Muhammad (pbuh) is considered to be the Magna Carta for the mankind. It was very short and powerful speech and culmination of his life-long preaching of the religion Islam. He basically mentioned three important points in his speech: a. Basic belief of one Allah; b. Rule of Law and morality; c. Rule of Justice. He put emphasis on economic justice by declaring *riba* haram, and declaring the sanctity of life, wealth and property. In his farewell speech regarding interest, the Prophet (pbuh) said: "Allah has forbidden you to take usury (interest); therefore all interest obligations shall henceforth be waived. Your capital is yours to keep. You will neither inflict nor suffer any inequity. Allah has judged that there shall be no interest". In this essay, we examine the principles of *riba* and how it fits within the realm of Islamic economics and banking, as it is exemplified by the Prophet in his Sunnah and as it is described in the Holy Qur'an.

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2. *Riba:* It's Prohibition in the *Shari`ah*

Riba is an Arabic word, derived from the verb *raba* that literally means 'to grow' or 'expand' or 'increase' or 'inflate' or 'excess'.[2] The same literary meaning has occurred in many places of *al-Qur'an* as well.[3] It is, however, not every growth or increase, which falls in the category of *riba* prohibited in Islam. It is generally translated into English as "usury" or "interest", but in fact it has a much broader sense in the *Shari`ah. Riba* in the *Shari`ah,* technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.[4] In *fiqh* [5] terminology, *riba* means an increase in one of two homogeneous equivalents being exchanged without this increase being accompanied by a return[6]. The term *riba* is, however, used in the *Shari`ah* in two senses. The first is *riba al-nasi'ah* and the second is *riba al-fadl.*[7] Some Muslim scholars attempt to define *riba* which seems to be closer to the sense implied in the verses of the *Qur'an* and *ahadith* related to it. They define *riba* as an increase or excess which, in an exchange or sale of a commodity, accrues to the owner (lender) without giving in return any equivalent counter-value or recompense to the other party.[8]

In the pre-Islamic and early Islamic era, *riba* signified the increase of money in consideration for an extension of the term of maturity of a loan. The pre-Islamic and early Islamic Arabs used to pay the money on loans and received a certain sum leaving the principal sum untouched. When the maturity date expired, they would claim the principal sum from the debtor; if it was not possible for the debtor to repay, they would increase the principal sum and extend the term. Thus, there were transactions with a fixed time limit and payment of interest, as well as speculations of all kinds that formed an essential element in the trading system of the pre-Islamic era. A debtor

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[2] Al-Raghib Al-Isfahani, Al-Husain, *Al-Mufradat Fi Gharaib* Al-Qur'an, Cairo, 1961, pp.186-187. The same meaning is also unanimously indicated in all classical Arabic Dictionaries and in the commentaries of *al*-Qur'an as well.

[3] Al-Qur'an, 30:39; 23:50; 2:265,276.

[4] Chapra, M. Umar, *Towards a Just Monetary System,* Leicester, 1986, pp.56-57.

[5] Muslim jurisprudence based on the Qur'an and the *Sunnah* and secondarily on *ijma`* and *ijtihad.*

[6] Al-Jaziri, `Abdal-Rahman, *Kitab al-Fiqh `ala al-Madhahib al-`Arba`ah*, Beirut, undated, p.245.

[7] *Riba al-nasi'ah* is the *riba* which the Prophet referred to when he said: "There is no *riba* except in *nasi'ah*" or waiting (Bukhari, *Kitab al-Buyu`, Bab Bai` al-Dinar bi al-Dinar nasa'an;* also Muslim, *Kitab al-Musaqat, Bab Bai` al-Ta`am Mithlan bi Mithlin).* While the authority for the definition of *Riba al-Fadl* lies in what the Prophet said in more than one occasion: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt – like for like, equal for equal, and hand to hand; if the commodities differ, the you may sell as you wish, provided that the exchange is hand-to-hand" (Muslim, *Kitab al-Musaqat, Bab al-Sarf wa Bai` al-Dhahab bi al-Waraq Naqdan;* also in Tirmidhi).

[8] Haque, Zia-ul-, *Islam and Feudalism: The Moral Economics of Usury, Interest and Profit,* Kuala Lumpur, 1995, p.16. See also, Joseph Schacht, *Encyclopedia of Islam,* 1939 edition, under 'Riba'.

who could not repay the debt i.e., money or goods, with the accumulated interest at the time it fell due was given an extension of time during which to pay, but at the same time the sum due was doubled. This is referred to clearly in *al-Qur'an*,

"O you who believe! Do not devour *riba* multiplying it over, and observe your duty to Allah that you may prosper" (3:10).

3. The Prohibition of *Riba* in the *Qur'an*

The prohibition of *riba* in *al-Qur'an* developed gradually and appeared in four revelations. The first revelation was revealed in Makkah before the prohibition of *riba* for which the verse paved the way. It says:

"And whatever you lay out with the people in order to obtain an increased return, this increases you nothing with Allah, but whatever you give in alms, seeking Allah's pleasure, it is those who receive multiplied recompense", [Chapter *al-Rum* (The Romans) 39].

The second revelation was revealed in Madinah, which mentions *riba:*

"Because of the sinfulness of the Jews, We have forbidden to them certain good things that were permitted to them, and for their hindering many from Allah's Way. And for their taking *riba*, though they were forbidden, and that they devoured people's wealth in falsehood, and We have prepared for the unbelievers among them a grievous chastisement" [*Al-Nisa`* (Women), 160-161].

This revelation created some misunderstanding among the scholars as to whether the prohibition is directed to Muslims or to the Jews in Madinah. The argument that the prohibition is directed to Muslims rather than the Jews seems to be stronger as because the discontentment with *riba* first occurred while Prophet Muhammad (pbuh) was still in Makkah and there were very few Jews in Madinah at that time. Besides, the Jews in Madinah were mostly involved in the agricultural sector and not in the commercial sector.

An express of prohibition follows in Chapter *'Al `Imran* (The Family of Imran), which mentions *riba* and bans it for the first time: "O you who believe! Do not devour *riba* multiplying it over, and keep your duty to Allah that you may prosper" [3:130].

This was the first verse revealed in Medina to impose a ban on *riba*. In interpreting this verse, the exegetes agreed that expression 'multiplying it over' does not restrict the ban but expresses *riba*

which people were accustomed to practise, assuming that this matter of multiples of multiples is no more than a description of state of affairs and not a condition relevant to the imposition.[9]
The prohibition of *riba* was intensified in Chapter *al-Baqarah* (The Heifer). The verses in question, the last to be revealed in Madinah concerning the prohibition of *riba* reads as follows:

"Those who devour *riba* will not stand except as one whom Satan has driven to madness by his touch will stand. That is because they say: 'Trading is like *riba*', and Allah has allowed trading and forbidden *riba*. So to whoever takes the admonition from his Lord, then he desists, he shall be pardoned for the past, and his affair is committed to Allah, but whoever reverts, those are the inhabitants of the Fire, to dwell therein forever. Allah will deprive *riba* of all blessing, and will give increase for deeds of charity; for Allah does not love any ungrateful sinner. Surely those who believe and do righteous deeds and establish prayer and pay alms, they shall have their reward with their Lord, and they shall have no fear, nor shall they sorrow. O you who believe! Keep your duty to Allah, and relinquish whatever remains from *riba* if you are indeed believers. But you do not, then be warned of a war from Allah and His Messenger, yet if you repent you shall have your capital fairly. And if the debtor is in difficulty grant him time until it is easier for him to repay, but if you are able, write off the debt as an act of charity, it would be better for you, if only you knew. And guard yourself against a Day in which you will be brought back to Allah, then every soul shall be recompensed in all fairness for what it has earned, and none shall be dealt with unjustly". [2:275-281]

In these verses *riba* is severely condemned and prohibited in the strongest possible terms. As instructed by *al-Qur'an* (in verse 280), creditors are urged to deal justly and fairly with debtors. In the event of debtors unable to pay their debt, the creditors are asked: (a) to give up even for claims arising out of the past on account of *riba,* (b) to give time for payment of principal if a debtor is in financial difficulties or, (c) to write off the debt altogether as an act of charity.

Thus, the verses mentioning *riba* show that all unlawful accumulation of wealth at the expense of others is condemned, and many different practices either by individuals or nations are covered by this ban. The principle is that any profit that human beings seek should be through their own exertions and not through the exploitation of others. *Al-Qur'an* regards *riba* as a practice of unbelievers, it demands, as a test of belief, that it should be abandoned.

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[9] Qutb, Sayyid, *Fi Zilal* Al-Qur'an, Beirut, 1997, p.60.

The above-mentioned verses prohibiting *riba* make no distinction between production and consumption loans. However, it may be suggested that this was because at that time loans were taken only for consumption purposes. Though much more research is needed, a good deal of documentary evidence has been adduced in recent years to show that loans for production purposes did exist during the time of the Prophet.[10] It has been shown that Arab traders at that time had close ties with the political and economic life of Middle Eastern countries where loans for production purposes had been common for hundreds of years. Historical records also show that on account of political conflicts between Rome and Persia, Arab traders of Makkah often worked as the *via media* for Roman trade with China, Indonesia, India, and Eastern Africa in the period close to the time of the Prophet. It is difficult to imagine, therefore, that loans for production purposes were absent in such conditions. Most of the commentaries on above mentioned verses relating to *riba* that have come down to us from scholars close to the time of the Prophet also make it explicit that loan transactions for business purposes involving *riba* did exist at that time.[11]

However, the absolute prohibition of *riba* in *al-Qur'an* is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without sharing the risk, while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* in *al-Qur'an* is therefore, a way to establish equity between the financiers and entrepreneurs. So, any attempt to treat the prohibition of *riba* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.

4. The Prohibition of *Riba* in the *Sunnah*

Al-Qur'an neither defines *riba* nor provides any detailed explanation about *riba.* The *hadiths* that deals with the subject are numerous, although sometimes the content of a particular *hadith* is slightly different from one narrator to another. So it will be sufficient to mention only some of them. The term *'riba'* is considered by *al-Qur'an* as *'riba al-nasi'ah''*[12] or delayed payment interest whereas the *hadith* explains *'riba al-fadl'* or increase interest.[13] The former refers to the

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[10] Al-Afghani, Sa`id, *'Aswaq al-`Arab Fi al-Jahiliyyah Wa al-Islam*, Beirut, 2nd ed., 1975, p.15.

[11] See in this connection, Sayyid Qutb, *Tafsir 'Ayat al-Riba*, Beirut: Dar al-Buhuth al-`Ilmiyyah, undated.

[12] *'Nasi'ah'* is elated to the verb *nasa'a*, meaning to 'postpone', 'defer' or 'wait'.

[13] The first time the Prophet dealt with *riba al-fadl* was when the tribe of Thaqif claimed repayment of its debt from the tribe of Mughira, a debt which remained from the pre-Islamic *riba.* The Prophet told the Thaqif that

time allowed to the borrower to repay the loan in return for addition or financial increment whether it is a fixed or a variable percentage of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. While the latter occurs when an item, available at the place of sale, is sold for an item, which is not available at the place of sale, even if the two items are exchanged for equal quantity in order to avoid increase interest. Equality in exchange of both items is not a condition here, owing to their dissimilarity. In practice, the *hadith* discusses both types of *riba* - *al-nasi'ah* and *al-fadl* - but its role in regard to the first kind is one of enforcement of Allah's commandment and assertion of what is banned.

The view on *riba al-fadl* is laid down in a number of *hadiths,* but the following is the most famous and accepted one, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, the like for the like, hand to hand (i.e., immediate sale), (but) if the kinds differ, then sell as you may like it from hand to hand".[14]

Another *hadith* is one narrated by Abu Sa`id al-Khudri from the Prophet who said: "Do not sell gold for gold, except when it is like for like, and do not increase one over the other; and do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away (from among these) for what is ready".[15]

Therefore, if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged on the spot and be equal and alike. Of the six specified commodities, gold and silver unmistakably represent commodity money whereas the other four represent staple food items. Muslim jurists have debated the question of whether *riba al-fadl* is confined only to these six items or if it can be generalised to include other commodities. Given the wide use of gold and silver as commodity money, the general conclusion is that all commodities used as medium of exchange enter the field of *riba al-fadl.* With respect to the other four items there is a difference of opinion among the Muslim scholars. However, the important point is, firstly that these considerable differences are a normal phenomenon in Islamic jurisprudence; and secondly, and

the Qur'an had ordered the abandonment of the remnants of pre-Islamic *riba*. The second time the Prophet dealt with the subject during his farewell pilgrimage. He said, "Every *riba* is abolished, and the first *riba* I abolish is ours-`Abbas Ibn `Abd al- Muttalib's *riba* - (i.e. the Prophet's relatives' *riba*). It is all abolished". See, Ahmad al-Baihaqi, *Al-Sunan al-Kubra,* Haidarabad, 1854, Chapter: 5, Hadith: 275.

[14] Prominent Muslim jurists - Ahmad, Bukhari, Muslims and others related this *hadith*.

[15] Bukhari, op. cit., Kitab al-Buyu`, Bab Bai` al-Fiddah bi al-Fiddah; also, *Sahih Muslim*, *Sunan al- Tirmidhi, Sunan al-Nasa'i* and *Musnad* of Ahmad.

much more importantly, in spite of these differences, the opinion of the majority of Muslim jurists is by no means likely to justify *riba al-nasi'ah* or *riba al-fadl.* All Muslim jurists are unanimous in their condemnation of *riba* and are backed by both *al-Qur'an* and the *hadith,* the main sources of the Islamic *Shari`ah.* A legal ruling issued by the Islamic scholars in the second conference of Islamic Researches Academy in 1965 practically and unequivocally, provides strong support for the complete agreement on the ban on *riba*.[16] Later, the *Fiqh* Academy of the Organaisation of Islamic Conference (OIC) supported the restrictive interpretation of *riba*, which had been adopted by the early jurists, condemning all interest-bearing transactions as void.[17]

5. Modernists Versus Conservatives' Views[18] on *Riba*

The origin of one part of the controversy between the modernists and the conservatives' views on *riba* dates back to early Islam, and it revolves around the question of what kind of *riba* the Qur'an really prohibited. Was it *riba al-nasi'ah,* which involves lending and borrowing, or *riba al-fadl,* which involves buying and selling?[19] One view is that in the early period of Islam, the Qur'anic injunctions against *riba* was understood to apply to loans in money and food, and anything beyond that is accepted to be later development.[20] Another authoritative view is that *riba al-fadl* has its origin in the *hadith,* and concludes that no attempt to define *riba* on the basis of the *hadith* has really been successful.[21] A more recent contribution claims that *riba* in both sales and loans existed before Islam, and *al-Qur'an* clearly implies that. Furthermore, the *hadith,* and the juristic formulations, therefore, are elaborations and extensions of the basic Qur'anic concept. It is also argued that *riba al-fadl* is merely a consequence of *riba al-nasi'ah*, since money can always be transformed into commodities.[22]

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[16] Ahmed, Osman Babikir, *The Contribution of Islamic Banking to Economic Development: The Case of The Sudan,* Ph.D. Thesis: Department of Economics, The University of Durham, 1990, p.32.

[17] Al-Omar, Fuad and Abdel-Haq Mohammed, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books Ltd., 1996, p.8.

[18] The term 'modernists' is referred to in this study some contemporary Muslim scholars like Fazlur Rahman (1964), Muhammad Asad (1984), Sa`id al-Najjar (1989), Sayyid Tantawi (1997) and others for whom it appears that prohibition of *riba* is due to the exploitation of the needy, rather than the concept of the interest rate itself. Keeping this in view, many of them attempt to differentiate between various forms of *riba* practised under the conventional banking system, advocating the lawfulness of some and rejecting others. While conservatives' views are referred to the traditional interpretation of *riba* which stresses on the point that any kind of interest falls under the banning of *riba.*

[19] Haque, Zia-ul, *Islam and Feudalism: The Moral Economy of Usury, Interest and Profit,* op.cit, pp.67-114.

[20] Schacht, Joseph, *An Introduction to Islamic Law,* Oxford, 1964, p.147.

[21] Rahman, Fazlur, "Riba and Interest", *Islamic Studies,* No.1, March 1964, p.30.

[22] Haque, Zia-ul, *Islam and Feudalism: The Moral Economy of Usury, Interest and Profit,* op. cit., p.102.

The controversy in its contemporary form turns on the definition of *riba* itself, whether the *riba* merely attached to profits obtained through interest-bearing loans involving exploitation of the economically weak by the strong and resourceful, or through all kinds of loan irrespective of the purposes; whether the prohibition is the form of *riba* practised in the pre-Islamic period; whether it prohibits usury but not interest or it prohibits the charging of interest altogether; whether it relates to loans for consumption or investment in a business venture; whether it prohibits nominal or real interest; whether the prohibition applies to compound or simple interest; and whether the ban relates to the borrower as individual or institution. According to the modernists' trend towards *riba,*[23] extra charges are permitted where they are used:

1. for the purposes other than exploiting the weak people of the community by the strong;
2. for loans that are similar to what were practised in the pre-Islamic period;
3. for the present form of interest-based banking transactions but not for usurious transactions transactions;
4. for business investment but not for consumption loans;
5. for the loss suffered by the creditor due to inflation;
6. for simple interest but not for compound interest; and
7. for institutional credit.

As opposed to this rather pragmatic viewpoint, the conservatives view forbids every form of fixed and predetermined interest.[24] They regard the levy of any fixed amount in excess of the principal lent prohibited by *al-Qur'an.* According to this view, since interest, however exorbitant or reasonable, is additional to the principal borrowed, it is a form of *riba* and therefore does not comply with *al-Qur'an.* Thus, *riba,* is defined as any predetermined fixed return for the use of money. Three main reasons are stated for strict condemnation of *riba* in Islam:[25]

1. *Riba* reinforces the tendency for wealth to accumulate in the hands of a few, and thereby diminishes human beings concern their fellow men.

2. Islam does not allow gain from financial activity unless the beneficiary is also subject to the risk of potential loss; the legal guarantee of at least nominal interest would be viewed as guaranteed gain.

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[23] Rahman, Fazlur, *Islam and Modernity: Transformation of an Intellectual Tradition,* Chicago: The University of Chicago Press, 1982, pp.30-33.

[24] Conservative views are expressed by among others Qureshi, *Islam and the Theory of Interest,* Lahore, 1991, p.100; Mannan, *Islamic Economics: Theory and Practice,* Delhi, 1980, p.218.

[25] Karsten, Ingo, *Islam and Financial Intermediation*, Washington D.C., IMF Staff Papers, 1982, p.111.

3. Islam regards the accumulation of wealth through interest or usury as selfish compared with accumulation through hard work and personal activity.

Several modernists and conservatives' views in regard to the *riba* along with their arguments are discussed below:

5.1. *Riba* is prohibited for exploitation and injustice

Modernists tend to emphasise the moral aspect of the prohibition of *riba*, and argue that the rationale for this prohibition as formulated in *al-Qur'an* was injustice and hardship.[26] They also find some support for their views in the works of some early scholars like Imam Razi[27] and Ibn Qayyim[28] for whom it appears that what is prohibited is the exploitation of the needy, rather than the interest itself. Many writers of this trend attempt to differentiate between various forms of interest practised under the conventional banking system, advocating the lawfulness of some, while rejecting others.[29]

As opposed to this view, it might be argued that the rationale for the prohibition of *riba* in *al-Qur'an* is to establish an economic system from which all forms of injustice and exploitation are eliminated, in particular, the injustice of the financiers being assured of a positive return without putting any effort or sharing in the risk,[30] while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* is therefore a way to establish justice between the lenders and borrowers.[31]

5.2. What is prohibited is pre-Islamic *Riba*

It has been claimed by some modernists that what is prohibited in *al-Qur'an* is the form of *riba* referred to the then prevailing practice of lending in the pre-Islamic era. Charging *riba* is found to

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[26] Al-Qur'an, 2:279.
[27] Al-Razi, Fakhr al-Din, *Al-Tafsir al-Kabir*, vol.7, Tehran, undated, p.94.
[28] Ibn al-Qayyim, Muhammad, *A`lam al-Muwaqqi`in 'An Rabbil `Alamin,* vol.2, Cairo, 1955, p.157.
[29] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking,* Cambridge, 1992, p.34.
[30] So far inflation is concerned; Islam unequivocally stresses justice in all measures of value. Hence, inflation, which brings continuous and significant erosion in the real value of money, is not compatible with the Islamic emphasis on balance and equilibrium. However, it was suggested that in the current world-wide inflationary climate, the Islamic imperative of socio-economic justice could be satisfied by indexation, or monetary correction, of all incomes and monetary assets. This proposal was given by Dr. Sultan Abu 'Ali in a seminar organised by the King Abdul Aziz University, Jeddah in October 1978, and was followed by a heated discussion by a committee of economists and Shari`ah scholars. For a detailed discussion in this regard, see Mohammad Ariff (ed.), *Monetary and Fiscal Economics of Islam,* Jeddah, 1982, pp.145- 186. Also Rafiq Y. Al-Masri, *Al-Jami` Fi 'Usul al-Riba,* Damascus, 1991, pp.237-239
[31] Al-Omar, Fuad and Abdel-Haq Mohammed, *Islamic Banking: Theory, Practice and Challenges,* op. cit., p.9.

be peculiar to pre-Islamic times and Arab territory. The debtor had to pay a fixed amount above the principal to the creditor for the use of money loaned for a certain period. This additional amount, which could be more than double the principal sum due, was prohibited by the Qur'anic injunction. According to this view, the first increase in a termed loan is lawful, but if, at maturity date, it were decided to postpone that maturity date against a further increase this would be prohibited. This view is apparently based on the reports came in *tafsir* (the commentary on *al-Qur'an)* of Ibn Jarir al-Tabari in relation to how *riba* was practised in the pre-Islamic period.[32] However, it does not explicitly and openly suggest that *riba* is acceptable without any qualification.

The critics of this view assert that the verse 130 of the chapter 3 in *al-Qur'an* is the first stage of the prohibition of *riba,* and that the term *'ad`afan muda`afatan'* (doubling and redoubling i.e., compound) mentioned in the verse is only explaining what the Arabs practiced, not that *riba* charged would be lawful if the amount were not doubled. Moreover, in their view, the last *riba*-related verses available in the chapter 2 (275-8) have clearly indicated that any increase over and above the principal should be *riba,* and as such it is unlawful. In this opinion, the later revealed verse overrides the previous verse. This applies to all kinds of *riba* – simple, compound, fixed or variable.[33] This view is also confirmed by an authentic *hadith* reported by al-Tabari and other expounders of the Qur'anic Exegesis where the Prophet says:

"Allah has decreed that there should be no *riba;* and each and every *riba (Kullu riban)* that was in period of *Jahiliyyah* (pre-Islamic) is under my two feet and I am making a beginning by remitting the amount of *riba* that my uncle Abbas has to receive".[34]

5.3. Interest Versus Usury

Another controversy on *riba* is due to the Qur'anic injunctions against *riba* whether it is 'interest', or 'usury'.[35] Modernists asserted that the *riba* which is prohibited, and on which there is consensus of opinion, is 'interest' when it equals the principal or more; but not 'usury'. The different

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[32] Al-Tabari, Muhammad Ibn Jarir, *Jami` al-Bayan Fi Tafsir* Al-Qur'an, vol.6, Beirut, 4th ed., 1980, p.27.

[33] Saeed, Abdullah, *Islamic Banking and the Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation,* Leiden, 1996, p.43.

[34] Ibn Kathir, 'Isma`il, *Tafsir al*-Qur'an *al-'Azim*, 1982, vol.1, pp.327-331 with reference from *Muslim* and *Abu Dawud;* Al-Tabari, Ibn Jarir, *Jami` al-Bayan,* vol. 6, op. cit., p.27; Al-Jassas, Ahmad, *Ahkam al- Qur`an,* vol.1, undated, p.558.

[35] See A. S. Hornby, *Oxford Advanced Learner's Dictionary,* New York, 2000. p.1433. It defines 'Usury' as 'the practice of lending money to people at unfairly high rate of interest'. So, an excessive rate especially above the rate fixed by the Government is a usurious rate of interest.

interpretations of this divine prohibition is traceable to the time of ‘Umar Ibn al-Khattab in the first century of the Islamic period, who was quoted as saying:

“The last to be revealed was the verse of usury and the Prophet demised without having made a clear pronouncement on the question of usury. Therefore, give up usury and anything resembling it”.[36]

It should be noted that in this translation the word ‘usury’ is used rather than ‘interest’, though it is not clear whether ‘Umar, by saying this, did mean ‘usury’ or ‘interest’ by *riba*. However, some modern English commentators of *al-Qur’an*, like Muhammad Asad,[37] have used the term ‘usury’ for *riba*. This interpretation comes close to the argument that a modern capitalist would make in favour of charging a positive rate of interest on a business loan under uncertainty with varying degrees of risk. Abdullah Yusuf Ali, who also translates *riba* as ‘usury’ in his brilliant English translation and commentary on the Qur’an, gives the most clear-cut case in favour of interest within the structure of modern credit and banking systems. He states:

“The definition I would accept would be: undue profit made, not in the way of legitimate trade, out of loans of gold and silver, and necessary articles of food, such as wheat, barley, dates, and salt (according to the list mentioned by the Holy Apostle himself). My definition would include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance”.[38]

This position, however, is rejected by several modern writers, like Mawdudi,[39]on the subject of *riba*. These writers generally interpret *riba* to mean ‘interest’ rather than ‘usury’.[40] They also argue that neither in Judaism nor in Christianity, had the distinction between the two terms - ‘interest’ and ‘usury’ - been recognised, let alone accommodated, until the Renaissance in Europe.[41] In Islam also there is no room for arguing that *riba* refers to ‘usury’ and not ‘interest’, because the nature of its prohibition is strict, absolute and unambiguous.[42] In additions, they refer to several *hadiths* in

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36 Ahmad, Al-Imam, *Al-Musnad*, ‘Bab al-Riba', vol.2, p.239; Ibn Majah, *Al-Sunan*, Kitab al-Tijarah, vol.2, p.764.

37 Asad, Muhammad, *The Message of The Qur’an*, Gibraltar, 1984, pp.61-62.

38 Ali, A. Yusuf, *The Holy Qur’an: Text, Translation and Commentary*, Lahore, 1975, p.111, n.324.

39 Mawdudi, Abul 'A`ala, *Towards Understanding the Qur'an*, Leicester, 1988. pp.213-286.

40 See, for example, Shaikh M. Ahmad, *Economics of Islam: A Comparative Study*, 2nd ed., Lahore, 1958; Anwar Iqbal Qureshi, *Islam and the Theory of Interest*, op.cit., M. Nejatullah Siddiqui, *Banking Without Interest*, Leicester, 1997; and S. A. Siddiqui, *Public Finance in Islam*, Lahore, 1962.

41 Al-Masri, Rafiq Yunis, *Masrif al-Tanmiyah al-Islami*, op.cit., p.81.

42 Al-Jaziri, `Abd al-Rahman, *Kitab al-Fiqh `ala al-Madhahib al-'Arba`ah*, op.cit., p.245.

support of their view that the Prophet prohibited the taking of even a small gift, service or favour as a condition for the loan, in addition to the principal.[43] Defending 'Umar's interpretation of *riba* they say that his words can, by no means, be interpreted to have narrowed down the prohibition of *riba* where his utterance "give up usury and anything resembling it" is in conformity with another saying of the Prophet "Leave what is doubtful in favour of what is not doubtful."[44] The degree of care in such circumstances, as they say, is more enhanced especially in face of the grave nature of *riba*, which is condemned outright by the Prophet.[45] They rejected Abdullah Yusuf Ali's definition arguing that *al-Qur'an* does describe one form of *riba* as undue increase, but *riba* was never defined as undue profit, neither in *al-Qur'an,* nor by the Prophet. According to their view, *riba* includes any material benefit above the capital sum lent, which a lender may derive from a borrower. Banks do not lend money for blessings, nor do they charge interest for the purpose of recovering losses sustained through inflation. They do it for profit. So, "economic credit, the creature of modern banking and finance" as they claim, is most definitely *riba,* regardless of whether the interest-rate is high or low or compound or simple. Thus, according to these writers, any attempt to differentiate between 'interest' and 'usury' in order to allow the former is an alien concept to the *Shari`ah.*

5.3. Consumption Loans Versus Investment Loans

Some modernists tend to differentiate between 'consumption loans' and 'investment loans', and argue that *riba* on consumption loans is unlawful, but it is lawful on investment or production loans.[46] The basis of the Qur'anic injunctions against *riba*, as they claim, is that those who borrow are assumed to be in need of such loans for purposes of maintaining some minimum standard of living. Therefore, *al-Qur'an* intended to prevent the exploitation of the economically weak people of the society, as well as to discourage excessive consumption. On the other hand, in the case of loans for business investment it is argued that the basic reason for the banning of *riba* is that it generates income without labour on the part of the lender.[47] They present some historical records to support this view as saying that in the early years of Islam borrowing for trade or commercial purposes was not practised, rather sharing and partnership were the only ways to increase the stock

[43] See for instance, the *hadith* narrated by Anas Ibn Malik- a companion of the Prophet- on the authority of al-Baihaqi in his *al-Sunan*: The Prophet said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually".

[44] Bukhari, *Sahih al-Bukhari,* Kitab al-Buyu`, vol.3, p.4; Al-Darimi, *Al-Sunan,* Kitab al-Buyu`, p.337.

[45] Musleh-Uddin, Mohammad, *Insurance and Islamic Law,* New Delhi, 1982, p.96.

[46] See for instance, Muhammad Abu Zahra, *Buhuth Fi al-Riba*, Kuwait: Dar al-Buhuth al-`Ilmiyyah, 1970, p.52.

[47] Noorzoy, M. Siddieq, "Islamic Laws on Riba (Interest) and their Economic Implications", *International Journal of Middle East Studies,* vol.14, 1982, p.4.

of capital. Furthermore, it is argued that seventh century Arabia knew mostly loans for consumption or distress purposes and not productive ventures. Therefore, *riba* charge on business loans is not forbidden in Islam.

On the opposite side of this view, orthodox writers, however, go to some length to disprove this contention. They argue that even if some kind of *riba*-based transactions were not practised at that time when this rule was made, it is still subject to that same rule. To support their view, they reason that when Qur'anic injunction came against *khamr* or alcoholic beverage, many of the drinks which are common today did not exist. Yet every one agrees that they are still prohibited. In addition, proponents of this view, questioning the historical evidence mentioned by the supporters of the modernists' view, present some other historical evidence to show that commercial loans were indeed common in the early Islamic society.[48] In favour of this view, an Egyptian scholar Shaikh Abu Zahrah pointed out that:

"There is absolutely no evidence to support the contention that the *riba* of *al-Jahiliyyah* (pre-Islamic *riba*) was on consumption loans. In fact the loans for which a research scholar finds support in history are production loans. The circumstances of the Arabs, the position of Makkah and the trade of Quraish, all lend support to the assertion that the loans were for production and not consumption purposes".[49]

The proponents of this conservative view also claim that in applying the Qur'anic injunctions against *riba* the Prophet himself did not make any distinction between consumption and production loans. Hence, according to this view, the prohibition of *riba* is deemed applicable to both the categories, and it is irrelevant whether it relates to loans for consumption or productive purposes.[50]

5.4. Nominal Versus Real Rate of Interest

Another controversy between modernist and conservative views on *riba* turns around its interpretation under inflationary and deflationary conditions. Modernists contend that although the Prophet was aware of the effect of inflation,[51] there is no *hadith* on *riba* that considers the effects of inflation and deflation on loan transactions. In fact, Inflation reduces the real purchasing power of

[48] Habibi, Nader, *The Economic Consequences of the Interest-Free Islamic Banking Systems*, Ph.D.Thesis: Michigan State University, 1987, pp.14-15.
[49] See M. Abu Zahrah, *Buhuth Fi al-Riba*, op. cit., pp.53-54.
[50] Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), *Readings in Islamic Banking*, Dhaka, 1987, pp. 42-43.
[51] Ali, S. A., *Economic Foundations of Islam*, Lahore, 1964, pp.22-23.

money, whereas deflation increases its purchasing power. Therefore, the proponents of modernists view suggest that in an inflationary economy, an interest rate which will correct the loss suffered by the creditor due to inflation could be justified by allowing an increase or interest to compensate for the loss of purchasing power of money. In support of this view, they argue that by means of the indexation of loans, i.e., by allowing interest up to the ceiling of inflation no real predetermined benefit is allowed to the lenders; rather this simply allows the lenders to retain the real value of their monetary asset intact. Inflation erodes the monetary asset of the lenders for no fault of their own.[52] Although Islam urges justice to the borrowers it does not approve of injustice to the lenders. Inflation undoubtedly does injustice to the *riba*-free lenders by eroding the real value of Benevolent Loan – a loan extended without either interest or profit sharing.[53] The outright prohibition of nominal interest indeed increases to cater for inflation would act as a disincentive to lend money which will have negative economic ramifications. So, it has been suggested that suitable interest and discount rate be devised to neutralise the effects of rising and falling prices.

The opponents of this view have, however, dismissed the arguments they set out on several grounds, maintaining that all kinds of increase related to loans transactions irrespective of nominal or real rate of interest, would be contrary to the Qur'anic injunctions against *riba*, and must be accepted as they stand. It is argued that the use of interest to neutralise inflation would tantamount to using a bigger 'evil' to fight a smaller one, and Islam does not encourage the introduction of new 'evils' to fight existing ones.[54] The general verdict of the Muslim jurists has so far been against indexation of loans as it involves an assured positive return on loans even though it is only in monetary and not real terms.[55] Hence, the question of nominal or real rate of interest does not arise; rather being *riba* any increase or interest should be considered unlawful. Moreover, the best conformity to the norm of socio-economic justice emphesised by Islam is price stability and not indexation of loans and assets.

5.5. Compound Versus Simple Interest

The proponents of modernists view towards *riba* say that its prohibition applies to compound and not to simple interest. In support of their argument they put forward the Qur'anic verse wherein it has been enjoined upon the believer not to devour usury, doubling and quadrupling. Besides other

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[52] Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), *op.cit.*, pp.45-46.
[53] Chapra, M. Umer, *Towards a Just Monetary System*, op.cit., p.40.
[54] Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), op.cit., p.46.
[55] Chapra, M. Umer, *Towards a Just Monetary System*, op.cit., p.40.

contention the opponents refer them to the Qur'anic verse which was revealed after the verse referred to by the modernists and which contains the words "And if you repent, then you have your principal (without interest)."[56] This verse clearly states that no more than principal is allowed to the creditor, which is further supported by the Prophet's declaration in his sermon on the occasion of the Farewell pilgrimage; "All *riba* is abolished, but you have your capital, wrong not and you shall not be wronged".[57] They contend that the same words "Wrong not and you shall not be wronged" appeared first in the Qur'anic verse (2:279) and then repeated in Prophet's saying to point out that neither would the debtor be tyranised over by being compelled to pay anything in addition to the principal nor the creditor suffers a loss in his or her principal.[58] Thus, no question of simple or compound interest can arise.

5.6. Individuals Versus Institutions

Some modernists contend that the larger financial institutions like banks and other institutions as exist today were not available at the time of the Prophet and hence bank interest and other institutional interest does not cover the prohibition of *riba*, the prohibition does cover only individuals. It is also viewed that taking *riba* by an individual from such institutions should not be prohibited because an individual cannot exploit a larger organisation like a bank, as they claim.[59]

As opposed to this view, it has been argued that if a modern bank is compared with individuals it is found as an institution, which borrows to lend. Thus, banks are institutions act as borrowers and lenders of funds, and in the process of borrowing and lending they receive and pay *riba*. The Qur'anic prohibition of *riba* is general in nature having universal application as it does not make any distinction between an institution and an individual in this regard. So, giving and taking *riba* by individuals or institutions fall under the same Qur'anic injunctions without any exemption. Furthermore, business institutions in present form though not necessarily were prevalent at that time, some of these business houses used to practise *riba* as a part of their business. The prohibition of *riba* was applied to them as well.

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[56] Al-Qur'an, 2:279.

[57] Ibn Hisham, Abu Muhammad Abdul Malik, *Al-Sirah al-Nabawiyyah,* vol. 2, Beirut, 1996, p.603.

[58] Al-Tabari, Muhammad Ibn Jarir, *Jami` al-Bayan Fi Tafsir* Al-Qur'an, op.cit., 1980, p.28.

[59] Khan, Abdul Jabbar, "Divine Banking System", *Journal of Islamic Banking and Finance,* winter 1984, pp.30-32.

In spite of these varying opinions, the modernists so far have failed to have much impact on contemporary debate on *riba.* Their views towards prohibition of *riba* have been met by some neo-revivalist critics, like Sayyid Qutb[60] and Mawdudi [61] with both economic and scriptural counter arguments, and their position has been undermined as they could not present a consistent theory of *riba* on the basis of the rationale of prohibition specified in *al-Qur'an.* Furthermore, the global rise of Islamic banking institutions inspired by neo-revivalist thinking on the issue of *riba*, which views that 'any interest is *riba,* and as such is prohibited.

6. Principles of Islamic Banking and Finance

Islam categorically prohibits its followers from dealings that involve *riba*.Yet Muslims need banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. Muslims are not averse to legitimate profit and Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle. Keeping this in view, the hallmark of Islamic banking is the prohibition of *riba* or interest, and there is now a general consensus among Muslim economists that *riba* is not restricted to usury but encompasses interest as well. The principles of Islamic banking and finance enshrined from *al-Qur'an* and Prophetic *Sunnah* are quite simple and can be summed up as follows:[62]

6.1. Any predetermined payment over and above the actual amount of principal is prohibited.

Islam allows only one kind of loan and that is *qard hassan* (literally known as benevolent loan), whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the *qard* or loan such as riding the borrower's mule, eating at his/her table, or even taking

[60] For a survey of arguments on interest see, Sayyid Qutb, *Tafsir 'Ayat al-Riba*, op.cit., also *Fi Zilal al- Qur'an*, op.cit.
[61] For more details see, Abul 'A`ala Mawdudi, *Al-Riba*, trans. Muhammad `Asim al-Haddad, Beirut, 1970
[62] Nida'ul Islam Magazine, "Principles of Islamic Banking", issue No.10, November-December 1995.

advantage of the shade of his/her wall".[63] The principle derived from the quotation emphasises that associated or indirect benefits are prohibited.

6.2. The lender must share in the profits or losses arising out of the enterprise for which the money was lent

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the *Shari`ah*, Islamic finance is based on the premise that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is in sharp contrast to the interest-based commercial banking system, where all the pressure is on the borrower: who must pay back the loan, with the agreed interest, regardless of the success or failure of the bank financed venture.

The principle, which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent).

6.3. Making money from money is not Islamically acceptable

As Islam views money as a medium of exchange; a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle as such hoarding money is regarded unacceptable. In Islam, money represents purchasing power, therefore, cannot be used to make more purchasing

[63] Al-Masri, Rafiq Yunis, *Al-Jami` Fi 'Usul al-Riba*, op. cit., 1991, p.256.

power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

6.4. *Gharar* (deception) and *Maisir* (gambling) are also prohibited

The word *gharar* is sometimes interpreted as meaning ‘uncertainty’ rather than deception. With regard to *gharar*, Islamic Law is clear that it should not be present in contractual agreement. One cannot for example sell what one does not own, because this is regarded as a form of deception. Similarly, one cannot sell an item of uncertain quality, an unborn calf for example, since the buyer and the seller do not know exactly what it is that they are trading. As far as *maisir* is concerned, it is regarded in Islam as one form of injustice in the appropriation of others’ wealth[64] and therefore has much in common with the concept of *riba*. The act of gambling, sometimes referred to betting on the occurrence of a future event, is prohibited and no reward accrues for the employment of spending of wealth that an individual may gain through means of gambling. Under this prohibition, any contract entered into, should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions.[65] Also, parties cannot predetermine a guaranteed profit. This is based on the principle of ‘uncertain gains’, which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as unIslamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

However, none of the above implies that a contract can be deemed invalid on the basis that the future outcome is not known. The future is always unknown from man’s point of view. But not knowing whether one shall make a profit as a result of entering into an investment contract is not the same as the lack of knowledge that exists where the subject matter of the investment contract itself is uncertain.[66]

A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of *qard hasan*. According to those scholars, the creditor

64 Al-Qur’an, 2:219.
65 Ahmad, Abu Umar Faruq, “Legislations and Issues on Islamic Banking in Bangladesh”, paper presented at the *First International Forum on Islamic Economics, Finance and Business for Young Scholars*, Langkawi, April 18-20, 2006.
66 El Diwany, Tarek, *The Problem With Interest*, London, 1997, pp.143-144.

advances the loan to win the blessings of Allah and expects to obtain the reward from Allah alone. However, there are number of transactions are treated as exceptions to the principle of *gharar* such as *bai` mu'ajjal* or sales with deferred payment, *bai` al-salam* sales with delivery of commodities and *ijarah* or leasing. However, there are legal requirements for the conclusion of these contracts to be organised in a way, which minimises risk.[67]

6.5. Investments should only support practices or products that are not forbidden or even discouraged by Islam.

Investments, according to the rules set by the *Shari`ah* should not be made for the products which are forbidden or even discouraged in Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

In summary, Islamic banking and finance stands for a system of equity-sharing and stake-taking. It operates on the principle of variable return based on actual productivity and performance of the projects, specific or general, individual or institutional, private or public. Economic cooperation may assume as many forms as may be desired, but the principle remains one of equity and reward sharing and not of simple loan-interest relationship as in the conventional banking system.

7. Islamic and Conventional Banking: A Comparison

Banking in the form in which it exists today is comparatively of recent origin. Before the advent of modern banking, direct finance, where the owner of capital deals directly with the user of capital, was the customary mode of transference of funds from savers to investors. With the progress of trade and industry and increased financing requirements of productive enterprises, direct finance proved an inadequate mechanism for such transference and banks emerged on the scene to undertake financial intermediation between savers and investors. Furthermore, in modern times, they emerged as organisations that engage in any or all of the various functions of banking, i.e., receiving, collecting, transferring, paying, lending, investing, dealing, exchanging, and servicing money and claim to money both domestically and internationally.[68] In its more specific

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[67] Ahmad, Abu Umar Faruq, "Problems of Islamic Banking in Bangladesh", paper presented at the Islamic Economics Research Bureau, Dhaka, Bangladesh, January 21, 2001.

[68] Woelfel, Charles J.' *Encyclopedia of Banking and Finance,* Chicago, 1993, p.69.

sense, however the term bank refers to institutions providing deposit facilities for the general public.

Perhaps the most striking feature in the structure of modern banking and finance is the use of credit institutions of accumulated wealth. Loans based on deposit funds provide financial support of the varied business and industrial enterprises in which men engage. Through credit, the accumulations of wealth, represented by bank deposits, have become a dynamic force in the modern world. Banking systems not only make the actual value of their deposit services available to society, but they have also multiplied the effective use of such funds by a system of discount and reserve which is of a comparatively recent origin.[69] Commercial banks perform all these functions and are considered to be the chief product of this age.

Therefore, the banks occupy very important position in a modern economy. Through the process of financial intermediation between savers and investors they exert immense employment and income generation effects, which ultimately help in economic advancement and social welfare. Another social welfare aspect of banks is through the provision of a return to the depositors, who are mainly small savers and include such weaker sections of the society such as widows, disabled orphans and the aged who could otherwise make no profitable use of their savings. Furthermore, the banks are manufactories of credit,[70] which serves the community and keeps the wheels of commerce and industry revolving. By offering opportunities for investment and safe custody of deposits, they stimulate the habit of saving, and discourage hoarding or the unproductive use of surplus wealth, thus promoting investment and the growth of capital. A wise banking policy may go a long way towards mitigating the shocks of an economic crisis, while a banking system, if badly constructed or badly handled, is capable of inflicting great harm on trade and industry and may even upset the whole economy.

The philosophical foundation of an Islamic financial system, where banking is the most developed part of this system goes beyond the interaction of factors of production and economic behaviour. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions, to enhance equality and fairness for the good of society as a whole. The similarities between the two systems are that in an Islamic system, banks, although

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[69] *Ibid.*, p.151.
[70] Kniffin, W.H., *How to Use Your Bank,* New York, 1937, p.31.

controlled by the rules of the *Shari`ah*, essentially perform the same functions as those in a conventional system; that is, they act as administrators of the economy's payments system and as financial intermediaries.[71] They are needed in both systems for the same reason – for the exploitation of imperfections in financial markets. These imperfections include imperfect divisibility of financial claims, imperfect information, transaction costs of search and acquisition, diversification by the surplus and deficit units, and existence of expertise and economies of scale in monitoring transactions.[72] Financial intermediaries in an Islamic system which operate in accordance with the *Shari`ah* can reasonably be expected to exhibit economies of scale with respect to these costs, as do their counterparts in a conventional system. Just as in the latter system, the Islamic depository financial intermediaries transform the liabilities of business into a variety of obligations to suit the tastes and circumstances of the surplus units.

Due to the nature of their operation, on the other hand, there are a lot of differences between Islamic and conventional banking. Contrary to Islamic banking, conventional banking has been defined as "accepting, for the purpose of lending or investing, deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise".[73] The Islamic banking has been defined by the International Association of Islamic Banks (IAIB) as "The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic *Shari`ah* in the fields of finance and other dealings. Moreover the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people."[74] Thus, it is evident that Islamic banking is different from conventional banking in terms of its mission and objectives. Therefore, obligations of Islamic banking toward society are greater than conventional banks, for the following reasons:

a) Islamic banking has certain philosophical missions to achieve. That is, since Allah is the Creator and Ultimate Owner of all resources, institutions or persons have a vicegerency role to

[71] Ahmad, Abu Umar Faruq, *Islamic Banking in Bangladesh,* unpublished LLM Thesis: University of Western Sydney, Australia, 2003.

[72] Iqbal, Zubair and Mirakhor, Abbas, *Islamic Banking,* Washington D.C., 1987, p.3.

[73] Meenai, Anwar Ahmed, "Islamic Banking – Where Are We Going Wrong?" *New Horizon,* London, February 1998, p.3.

[74] IAIB (The International Association of Islamic Banks), *Directory of Islamic Banks and Financial Institutions,* Jeddah, 2001.

play in society. Therefore, Islamic banks are not free to do as they wish; rather they have to integrate moral values with economic action.

b) To provide credit to those who have the talent and the expertise but cannot provide collateral to the conventional financial institutions, thereby strengthening the grass-root foundations of society; and

c) To create harmony in society based on the Islamic concept of sharing and caring in order to achieve economic, financial and political stability.

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.

In Islamic banking, on the other hand, since a loan is considered to be given or taken, free of charge, to meet any contingency, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that *"Deal not unjustly, and you shall not be dealt with unjustly"*. [2:279]

Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk.[75]

Thus, financial intermediation in an Islamic framework has been developed on the basis of the above two principles. Consequently financial relationships in Islam have been participatory in nature. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities.[76]

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[75] Ahmad, Ausaf, "The Evaluation of Islamic Banking" in *Encyclopedia of Islamic Banking*, London, 1995, p.17.

[76] Mangla, I. Y., and Uppal, J. Y., "Islamic Banking: a Survey and Some Operational Issues", *Research in Financial Service*, vol. 2, 1990, pp.179,185,215.

The distinct characteristics which provide Islamic banking with its main points of departure from the traditional interest-based commercial banking system are: (a) the Islamic banking system is essentially a profit and loss sharing system and not an interest banking system; and (b) investment (loans and advances in the conventional sense) under this system of banking must serve simultaneously both the benefit to the investor and the benefit of the local community as well.

The distinguishing features of the conventional banking and Islamic banking may be shown in terms of a box diagram as under.

Conventional banking	**Islamic banking**
1. The functions and operating modes of conventional banks are based on man-made principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic *Shari`ah.*
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3. It aims at maximising profit without any restriction.	3. It also aims at maximising profit but subject to *Shari`ah* restrictions.
4. It does not deal with *zakah.*	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to collect and distribute *zakah.*
5. Lending money and getting it back with interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks.
6. Its scope of activities is narrower when compared with an Islamic bank.	6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.
7. It can charge additional money (compound rate of interest) in case of defaulters.	7. The Islamic banks have no provision to charge any extra money from the defaulters.
8. In it very often, bank’s own interest becomes prominent. It makes no effort to ensure growth with equity.	8. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.

9. For interest-based commercial banks, borrowing from the money market is relatively easier.	9. For Islamic banks, it is comparatively difficult to borrow money from the money market.
10. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	10. Since it shares profit and loss, Islamic banks pay greater attention to developing project appraisal and evaluations.
11. Conventional banks give greater emphasis on credit-worthiness of the clients.	11. Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	12. The status of Islamic bank in relation to its clients is that of partners, investors and trader.
13. A conventional bank has to guarantee all its deposits.	13. Strictly speaking, an Islamic bank cannot guarantee all its deposits.

In spite of the differences mentioned above between the Islamic and Conventional banks, both have something in common. Since Islamic banks do not rent money, and therefore do not charge interest, they have developed some investment techniques such as *bai` murabahah, musharakah* and *mudarabah* in order to invest money and make profit. In any of these techniques, profitability and installment of repayment are identified beforehand. In additions, some Islamic banks practice certain forms of leasing.[77] Many of the services handled by conventional banks and not related to interest, such as letters of credits, collections, foreign exchange, financial advising etc., are performed by Islamic banks. Some Muslim banks handle a large percentage of the Islamic bank's money in the commodities markets. If it is considered that banks and financial institutions measure their success in terms of Returns on Assets (ROA), the commodity transaction can be developed to achieve the goals of the parties concerned – the Islamic bank, the conventional bank and the client of the conventional bank.[78]

8. Socioeconomic Consequences of Islamic Banking

The possible socioeconomic consequences of Islamic banking have been the subject matter of extended discussion in recent literature mainly on the basis of presumption that PLS modes of financing of Islamic banking will have a dominant role while the other modes would be used

[77] Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "The Time Value of Money Concept in Islamic Finance", *American Journal of Islamic Social Sciences*, Herndon, USA, 23, 66-89.

[78] Qasim, M. Qasim, "Islamic Banking, New Opportunities for Cooperation Between Western and Islamic Financial Institutions", in Butterworths (eds.), *Islamic Banking and Finance*, London, 1986, p.19-20.

sparingly.[79] The major focus of discussion has been on the possible impact of Islamic banking on the following specific areas.

a) Impact on Saving and Investment

Concerns have been expressed in the literature on Islamic banking that adoption of an interest free system may have an adverse effect on saving because of increased uncertainty in the rate of return.[80] Muslim economists have argued that the actual income would depend on a number of factors such as the form of utility function and its risk properties, for example, the degree and the extent of risk aversion, the degree to which future is discounted, whether or not increased risk is compensated by higher return, and finally the income and substitution effects of increased uncertainty.[81] It has further been argued that the move to an Islamic interest free system, under certain conditions, could lead to increased rates of return on savings. Consequently, the increased level of uncertainty that could result from adoption of PLS based system could be compensated for by an increased rate of return on savings, leaving the overall level of savings unchanged or perhaps even leading to an increase in savings.[82]

As regard to the possible impact of Islamic banking on the level of investment, Muslim economists pointed out that both the demand for investment funds and the supply of investment funds are likely to show an increase consequent to replacement of interest based banking by PLS based banking. The demand for investment funds is likely to increase, as a fixed cost of capital is no longer required to be met as a part of the firm's profit calculations.[83] The marginal product of capital can, therefore, be taken up to the point where maximum profits are obtained without the constraint of meeting a fixed cost of capital. The supply of investment funds is likely to increase as PLS based bank are enable to undertake the financing of a larger number of risky projects on account of an enhanced risk absorbing capacity.[84]

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[79] Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "Regulation and Performance of Islamic Banking in Bangladesh", *Thunderbird International Business Review*, 49, 2007.

[80] Pryor, Fredric L., "The Islamic Economic System", in *Journal of Comparative Economics*, vol.19, 1985, p.197.

[81] See, Zubair Iqbal, and Abbas Mirakhor, *Islamic Banking*, op. cit., pp.5.

[82] Haque, Nadeem ul and Abbas Mirakhor, "Optimal Profit-Sharing Contracts and Investment in an Interest Free Economy", in Mohsin S. Khan and Abbas Mirakhor (eds.), *Theoretical Studies in Islamic Banking and Finance*, Houston, 1987, pp.141-166.

[83] Ahmad, Abu Umar Faruq, "Islamic Banking in Bangladesh: Legal and Regulatory Issues", paper presented at the Sixth Harvard University Forum on Islamic Finance, May 8-9, Cambridge, MA.

[84] For some important contributions on the subject, see the study by Nadim ul Haque and Abbas Mirakhor mentioned in the preceding note and also M. Umer Chapra, *Towards a Just Monetary System*, op.cit., pp.111-117, and M. Nejatullah Siddiqi, *Issues in Islamic Banking*, op.cit., pp.88-89.

b) Impact on the Rate and Pattern of Growth

Several scholars have pointed out that the expected favourable impact of PLS based banking on the level of investment would impart a distinct growth orientation to the economy.[85] The increased availability of risk capital under the Islamic system would promote technological innovation and experimentation, which would be another plus factor for growth. Islamic banks are also expected to influence the pattern of growth through appropriate selectivity in their financial operations to ensure that the process of growth is broad based and an optimal use of bank resources is made for purposes, which rank high in Islamic socioeconomic objectives.

c) Impact on Allocative Efficiency

Allocative efficiency of a financial system based on an Islamic framework of profit sharing has been an area of major concern in the literatures of many Muslim economists.[86] It has been pointed out that Islamic banking would be more efficient in allocating resources as compared to the conventional interest based system. This position is defended on the basis of the general proposition that any financial development that causes investment alternatives to be compared to one another, strictly based on their productivity and rates of return, is bound to produce allocative improvements, and such a proposition is the cornerstone of the Islamic financial system. Muslim scholars emphasised in their writings that non-existence of interest does not mean that discounting as a technique of computing the present value of future cash flows cannot be used in an interest free economy. It has further been pointed out that interest rate is not the proper discount factor under conditions of uncertainty even in interest based economies. Under conditions of uncertainty, the rate of return on equity is the proper discount rate. Since the real world is a world of uncertainty, and no real investment in any economy can be undertaken without facing risks, cash flows of such investment should be discounted not by a riskless interest rate but by the true opportunity cost of venture capital.[87]

d) Impact on the Stability of the Banking System

It has been argued in the writings on Islamic banking by some writers that a switch over from interest based banking to PLS based banking would impart greater stability to the banking system. In the interest based system, the nominal value of deposit liabilities is fixed and no assurance that all the loans and advances will be recovered. Shocks on the assets side, therefore, lead to divergence

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[85] See, for example, M. Umer Chapra, *Towards a Just Monetary System*, op. cit., pp.122-125.

[86] See, especially, M. Anas Zarqa, "Capital Allocation, Efficiency and Growth in an Interest-Free Islamic Economy", in *Journal of Economics and Administration*, 1982, pp.43-55.

[87] For an elaboration of this theme, see M. Anas Zarqa, "An Islamic Perspective on the Economics of Discounting in Project Evaluation" in Ziauddin Ahmad et al (eds.), *Fiscal Policy and Resource Allocation in Islam*, 1983, pp.203-234.

between assets and liabilities, and the banking system can suffer a loss of confidence in the process, leading to banking crises. On the other hand, in the PLS based system, the nominal value of investment deposits is not guaranteed, and shocks to the assets positions are promptly absorbed in the values of investment deposits. This minimises the risk of bank failures and enhances the stability of the banking system.[88]

e) Impact on the Stability of the Economic System

Muslim scholars in their literature on Islamic banking have taken note of apprehensions expressed in certain circles that replacement of interest by PLS may make the whole economic system highly unstable as disturbances originating in one part of the economy will be transmitted to the rest of the economy.[89] Such apprehensions are viewed by them to be lacking in substance and they suggest, on the contrary, that elimination of interest, coupled with other institutional features of an Islamic economy, will tend to enhance stability. It has been pointed out that interest based debt financing is a major factor in causing economic instability in capitalist economies. When the interest-based banks for example, find the business for what they sanctioned loans are beginning to incur losses, they reduce assistance and call back loans, which results in closing down that business. This increases unemployment, which leads to further reduction in demand, and the infection spreads. Islamic banks, on the other hand, are prepared to share in losses, which reduces the severity of business recession and enables the productive enterprises to tide over difficult periods without a shut down. Islamic banking has, therefore, to be regarded as a promoter of stability rather than instability.[90]

8. Conclusions

The basic objective of Islamic banking, as emphasised in the *Handbook of Islamic Banking* (HIB),[91] is to provide financial facilities by developing financial instruments that conform with the Islamic rules and norms, the *Shari`ah.* The Handbook mentions: “the primary goal of Islamic banking is not to maximise the profit as the interest-based banking system does, but rather to render socio-economic benefits to the Muslims”. [92]

[88] See Mohsin, S. Khan, "Islamic Interest Free Banking: A Theoretical Analysis”, in Mohsin S. Khan and Abbas Mirakhor (eds.), *Theoretical Studies in Islamic Banking and Finance*, 1987, pp.15-35.
[89] See S. N. H. Naqvi, *Ethics and Economics: An Islamic Synthesis*, Leicester, 1981, p.136.
[90] See M. Anas Zarqa, “Stability in an Interest-Free Islamic Economy: A Note”, *Pakistan Journal of Applied Economics*, winter 1983, pp.181-188.
[91] HIB (Hand Book of Islamic Banking), IAIB, Jeddah, 1982, vol.5, p.153.
[92] *Ibid*., pp.153-55.

In additions, Islamic banking conforms to philosophical underpinning of Islam. Since Allah is the creator and ultimate owner of the universe, institutions or human beings have a vicegerency role to play in society. Therefore, banking institutions have to integrate moral values with economic action. Money and other resources are thus social tools to achieve optimum social good and welfare.
In view of the above, the objectives of Islamic banking are to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs services and to promote products based on Islamic principles. As discussed earlier in this study, Islam is a complete code of life and as such prescribes the manner in which all actions of a Muslim ought to be conducted. Therefore, conducting worldly affairs, including banking, in the manner prescribed by the *Shari`ah* is an obligation of a Muslim is viewed as an act of worship.

These objectives have truly reflected in the functions of Islamic bank as determined by the International Association of Islamic Banks (IAIB) in the following few sentences:

"The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic *Shari`ah* in the fields of finance and other dealings. Moreover, the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people". [93]

The objectives and philosophies of Islamic banking are thus in line with the revelations in *al-Qur'an* and the *hadith*, and it is expected to be guided by these philosophies. Establishing the right philosophies is important for any Islamic banking or financial institution mainly for two reasons.

Firstly, these philosophies will be used by the management or policy makers of Islamic banks in the process of formulating corporate objectives and policies.

Secondly, these philosophies serve as an indicator as to whether a particular Islamic bank is upholding true Islamic principles or not. In this connection, it needs to be emphasised that while the

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[93] Ali, Manzoor, "Islamic Banking: Concept and Practice", *Pakistan & Gulf Economist*, January 1985, p.13.

riba is prohibited in Islam, earning or profit on investment in trade and business is permitted and encouraged provided that the related risks and gains are not one-sided but balanced. So, from the religious perspective, the establishment of an Islamic bank is considered to be a righteous move having its involvement in legitimate trade; and for paving the way to perform banking business in line with the *Shari`ah*.

Eliminating *riba* in the banking system is an indispensable part of Islamic business principles. Management and staff of this system are bound to conduct their business with conformity to Islamic business principles in addition to the normal objective of profit maximisation. These principles include honesty, justice and equity as ordained by Allah and practiced by Allah's Prophet. In the process of conducting business, Islamic banking seeks to balance between earning and spending with a view to maximise social benefit. It should be emphasised that in Islam earning should be lawful. In terms of spending wealth, it demands its followers to spend for the welfare of the people and not to waste nor use it in illegitimate ways. Islamic banks' relationship with their clientele is not that of a lender and borrower but that of a business partner. Several Muslim scholars have emphasised the point that since Islamic banks are committed to work on the basis of a completely different philosophy, they should have a pronounced orientation towards channeling resources to poorer sections of society so as to improve their economic well being in line with the Islamic socio-economic objectives.

It may be argued that some of the objectives and functions of Islamic banking system, as stated above, are the same as those under conventional banking system. Though there may be an apparent similarity, there is in fact a significant difference in emphasis, arising from the divergence in the commitment of the two systems to spiritual values, socio-economic justice and human brotherhood as the goals and objectives in Islam are inviolable part of the ideology and the faith.

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